Deep Learning in Asset Pricing
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Abstract
We estimate a general non-linear asset pricing model and optimal portfolios with deep neural networks applied to U.S. equity data combined with a substantive set of macroeconomic and firm-specific information. Our crucial innovation is the use of the no-arbitrage constraints as part of the neural network architecture. We estimate the stochastic discount factor (SDF) or pricing kernel that explains all asset prices from the conditional moment constraints implied by no-arbitrage. For this purpose, we combine three different deep neural network structures in a novel way: A feed-forward network to capture non-linearities, a recurrent (LSTM) network to find a small set of economic state processes, and a generative adversarial network to identify the portfolio strategies with the most unexplained pricing information. Our SDF is a portfolio of all traded assets with time-varying portfolio weights which are general functions of the observable time-specific and macroeconomic variables. Our model allows us to understand what are the key factors that drive asset prices, identify the portfolio strategies with the most unexplained pricing information. Empirically, our optimal portfolio strategies have a risk-adjusted return out-of-sample (annual Sharpe-ratio 2.1) that outperforms all other benchmark models in the literature.

Introduction
Machine Learning in Finance
In efficient markets, asset returns are dominated by unforeseeable news. Hence, financial returns exhibit a very low signal-to-noise ratio which distinguishes them from other applications of machine learning. In this paper we include financial constraints (no-arbitrage) in the learning algorithm to significantly improve the signal and obtain considerably better results than with off-the-shelf machine learning algorithms.

Research questions:
1. Explain asset prices for different assets
2. Design optimal risk-adjusted portfolios
3. Find mis-priced assets to earn alpha
4. Use all available information in the market and understand which information is relevant

This Paper
We estimate the pricing model with deep neural networks. The crucial innovation is to include the no-arbitrage condition in the neural network architecture and combine three neural network structures in a novel way:
1. Non-linearity: Feed-forward network captures non-linearities
2. Time-variation: Recurrent (LSTM) network finds a small set of economic state processes
3. Pricing all assets: Generative adversarial network identifies the states and portfolios with most unexplained pricing information
4. Dimension reduction: Regularization through no-arbitrage condition
5. Signal-to-noise ratio: No-arbitrage conditions increase the signal-to-noise ratio

Model

Loss Function (General Method of Moments)
We estimate the weights of the SDF portfolio by minimizing the fundamental no-arbitrage moment conditions. The pricing formula is equivalent to an infinite number of moment conditions. For any \( F_t \)-measurable variable \( I_t \), the corresponding moment condition equals
\[
E[F_t^i | R_{t+1}] = 0
\]
which implies a loss function. The empirical loss function minimizes the sample mean pricing error corrected for the different number of time-series observations for each asset:
\[
L(I) = \frac{1}{N} \sum_{t=0}^{T} \left( \frac{1}{T} \sum_{t=1}^{T} \left( \sum_{i=1}^{I} M_{t,i} R_{t+1}^i \right) \right)^2
\]

Recurrence Neural Network
We use recurrent neural network (RNN) with Long-Short-Term-Memory (LSTM) cells to transform all macroeconomic time-series into a low dimensional vector of stationary state variables. This is because:
1. Economic time-series data is often non-stationary. Therefore, necessary transformation is required.
2. Asset prices depend on economic states. Therefore, simple differencing of non-stationary data is not sufficient.
3. Four macro state variables (LSTM outputs) are enough to capture macroeconomic movements.

GAN - Generative Adversarial Network
SDF Network and Conditional play a zero-sum game. We iteratively update the two networks. For a given conditional variable \( I_t \), the SDF Network minimizes the loss. For a given SDF network, the Conditional Network serves as an adversary and competes with the SDF Network to identify the assets and portfolio strategies that are the hardest to explain.

Model Interpretation and Structure of Weights

No-Arbitrage Asset Pricing

The Stochastic Discount Factor (SDF)
The key object in No-Arbitrage Pricing Theory (APT) is the stochastic discount factor (SDF) or pricing kernel that explains differences in risk and asset prices. It is defined as a stochastic process \( \{ M_t \} \) such that for any security with payoff \( F_{t+1} \) at time \( t+1 \), the price of that security at time \( t \) is
\[
F_t = E[M_{t+1} F_{t+1}^i] \tag{1}
\]
Equivalently the fundamental no-arbitrage condition can be expressed as
\[
E[R_{t, i} | F_t] = \beta E[R_{t+1} | F_t]
\]
where \( M_{t,i} R_{t+1} = R_{t,i} - R_{t+1} \) is the excess return (return minus risk-free rate) of asset \( i \) at time \( t+1 \). Without loss of generality the SDF is the gross return of the SDF portfolio:
\[
M_{t,i} = 1 + \sum_{i=1}^{I} w_i R_{t,i} \tag{2}
\]
The SDF portfolio \( \sum_{i=1}^{I} w_i R_{t,i} \) is the mean-variance efficient portfolio with the highest conditional Sharpe-ratio.

Equivalent factor model representation
The no-arbitrage condition yields a beta representation
\[
E[R_{t+1} | F_t] = \beta E[R_{t+1} | F_t] + \beta E[R_{t} | F_t] \tag{3}
\]
with factor \( F_t = 1 - M_t \). Without loss of generality no-arbitrage is equivalent to a one-factor model with time-varying loadings:
\[
R_{t+1} = \beta R_{t+1} + \epsilon_{t+1}
\]
We estimate portfolio weights of the SDF portfolio and the risk-exposure \( \beta \) as general functions of all available information at time \( t \).

Model Evaluation

Evaluation Metrics
We evaluate the performance of our model by calculating the Sharpe-ratio of the SDF portfolio, the amount of unexplained variation and the pricing errors of the model. We obtain the systematic and non-systematic return component by projecting returns on the risk exposure \( \beta \), which is estimated by fitting a feed-forward network to predict \( E[R_{t+1} | F_t] \).

Predictive Pricing Performance
• Portfolios with higher predicted \( \beta \) have higher average returns. We sort stocks into decile portfolios based on their conditional \( \beta \). The first decile portfolio is based on the smallest and the last on the largest decile.

Data

Returns and Firm Specific Characteristic Variables
We obtain monthly equity returns data for all securities on CRSP from 1967 to 2016. We constructed 46 firm-specific characteristics either defined on the Kenneth French Data Library or compiled by Freyberger et al. (2018). All these variables are constructed from either accounting variables from CRSP/Compustat database or past returns from CRSP.

Macroeconomic Variables
We constructed a collection of 178 macroeconomic variables, which come from three sources. We take 124 macroeconomic predictors from the FRED-MD database. We also take cross-sectional median time series of the 46 firm characteristics and an additional 8 macroeconomic predictors from Welch et al. (2007).

Empirical Results

Performance on Individual Stocks
• Our SDF portfolio has the highest risk-adjusted payoff (Sharpe-ratio) out-of-sample and lower risk as measure by drawdown:

Model Interpretation and Structure of Weights

Non-linear interactions between characteristics are important, which cannot be captured by standard models. The plots show the non-linear relationship in the SDF portfolio weights for Short-Term Reversal (ST_REV), Momentum (r12,2) and Standard Unexplained Volume (SUV) and their interactions.